

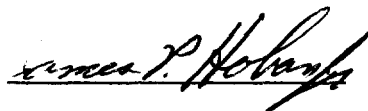
The Rise of U.S. Banking Institutions

An Honors Thesis (HONRS 499)

by

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Abstract

The purpose of this paper is to make us aware that the United States is losing ground in terms of competitiveness with other countries around the world. We are not only losing ground in the engineering and automobile industry, but also the banking industry.

There are several ways to make the U.S. banking industry more competitive. Reforms are needed to increase the strength of the Bank Insurance Fund (BIF), the different regions in the country, and the banks themselves. U.S. banks are now offering more services to make it more attractive and convenient for their customers.

Introduction

The U.S. banking system was once the strongest banking institution in the world, but in recent decades it has declined. There are several issues that must be dealt with in order for the U.S. banks to climb back up to the solid institution it once was.

One of the greatest concerns of the industry is the stability of the Bank Insurance Fund (BIF). Could it sustain the bankruptcy of a large bank? Another concern is that the competitiveness of U.S. banks is declining from an international perspective.

Regulatory reforms are needed to make the U.S. financial institutions more competitive.

The future also calls for banks to offer more services for consumer satisfaction.

The Decline of U.S. Banking Institutions

The future of the American banking system is in doubt. The decline of American banks began in about the early 1980's, when commercial bank loans to lesser developed countries began to default (Barth). Most banks learned the hard way that extending higher-yielding, but risky loans to non-creditworthy ventures was one of the causes for the downfall of many banks in the 80's and early 1990's. Banks have learned their lesson and have started to diversify the risk. Thus, earnings can be earned in a more consistent stream (Herman).

The difficulties for the banks began to unfold at the end of 80s, when it became conceivable that bank insolvency costs could rise so high that they would not only deplete the Bank Insurance Fund (BIF) administered by the FDIC, but also that the costs would exhaust the financial ability of healthy banks to pay for insolvencies. Taxpayer dollars may be needed to resolve bank failures as occurred in the Savings and Loan debacle (Barth).

It is disturbing to find that many of the largest banks fail to meet the risk-based capital standards adopted by U.S. bank regulators and other major industrialized countries. According to a Federal Reserve Board analysis, by the end of 1989, 591 banks with a total of almost 28 percent of the nations banking assets, including assets in twenty of the largest banks in the country, did not meet the risk-adjusted capital standards that were fully effective January 1, 1993. Also, in the fall of 1989 Senate testimony, the Comptroller of the Currency reported that almost 700 banks holding more than 40 percent of all bank assets did not meet the new risk-adjusted standards. These figures are important because they reflect the regulator's collective judgment about the minimum amounts of capital banks should have to protect the Bank Insurance Fund and to prevent their managers from taking excessive risks.

With the weakness in the U.S. banking system centered in the largest banks, a significant number of unprecedented problems arise. A single large bank closure, for example, could eliminate all the BIF's cash resources and possibly even effect direct taxpayer expenditures. Until the deterioration of banks is officially acknowledged, it will be impossible to drum up support for meaningful reform of federal deposit insurance and insured depositories to prevent recurrence.

Competition from Other Financial Institutions

Competition between banks and savings institutions has lessened somewhat due to the passage of the Truth in Savings Act on June 21, 1993. This act requires federally insured banks and savings institutions to disclose certain account information in a standard fashion so consumers could make better decision about where to put their money. Banks have to use a uniform formula for calculating interest yields that is based

on the full balance in an account each day (Berzof). Previously, some banks paid interest only on the smallest amount of money in an account on any one day during the interest period. This low-balance method penalized accounts with balances that fluctuated greatly. Others used the investable balance method, withholding interest on a portion of a deposit, claiming that they had to set aside that amount in a non-interest-bearing account as "reserves." This meant that while a bank may advertise that it's paying depositors 4 percent, it's actually paying much less (Rumbler). The Truth in Savings Act also requires uniform terminology. Banks must disclose the interest on accounts in annual percentage yield, enabling consumers to compare rates. For example, if a bank's annual percentage yield (APY) is greater, either the bank is paying a higher simple interest rate or they are compounding more frequently. Also, due to this act, banks will be required to give their investors a more itemized accounting of their service charges and no longer will be able to label something "free" when it has hidden fees or minimum-balance requirements. In addition, in circumstances when a certificate of deposit renews automatically, the bank must notify the holder 20 to 30 days before it matures and send the telephone number to call to learn the new rates. Some banks were already following the guidelines but the act costs other banks and thrifts a lot of money (Berzof).

Due to the Truth in Savings Act, competition among banks has decreased. There are new types of institutions which serve as new competition for banks, pawnshops. The modern pawnshop is aimed at yuppie bargain hunters or those with occasional cash-flow problems looking for a quick loan. Pawnshops have often been located in depressed areas or older communities, but as people become more cost conscious in the

'90s, they discover that pawnshops offer some of the best bargains around. Pawnshops also are an alternative to those who cannot use a traditional lending source. It is difficult to get small loans today. People sometimes do not have enough net worth to borrow the little money they need to pay the monthly bills. Despite their shaky stereotype, pawnshops actually are lending institutions strictly regulated by the Indiana Department of Financial Institutions.

At a pawnshop, money is borrowed against a piece of merchandise, which becomes the collateral for the loan, just as a house is the collateral for a mortgage. Charges include interest, storage and handling. If the item is not redeemed within 90 days, the owner is given written notification that it will be offered for sale. Aside from cash advances on credit cards, there are few sources for loans of less than \$1000. Tighter lending rules in the banking industry have had an impact on pawnbrokers. With pawnshops, there are no applications, employment requirements or questions asked. Pawnshops are quick, but like any convenience, they cost more (Parta).

International Perspective

There is a growing concern about what is perceived a decline in the competitiveness of U.S. industry. Foreign companies are taking markets away from U.S. companies in industry after industry, including the automobile, electronics, and apparel industries. In banking, too, the competitiveness of U.S. banks seems to be decreasing. Major U.S. money center banks have been closing foreign offices while banks from other countries are expanding. In addition, commercial and industrial loans rose 38.7 percent at foreign banks in the U.S. in 1990, but fell at domestic banks. The

interest in banking is part of the mounting concern that the U.S. faces a decline in its ability to compete in selling services similar to its decline in manufacturing.

If a nation's industries are going to be competitive in global markets, they need the most efficient resources. That means U.S. industry needs a banking system that is prepared to find and employ the best and least expensive financing markets and instruments, regardless of where they are to be found (Bellanger).

International banking capabilities are important not only in raising funds but also in collecting and disseminating market information. Banks familiar with foreign markets can help their customers penetrate those markets. Finally, U.S. banks are significant as employers, taxpayers, and purchasers of goods and services. If they lose ground to overseas banks and this country's financial centers shrink, it will have the same kind of negative impact as when a manufacturer moves to Hong Kong.

Competitiveness is determined by the quality and price of services offered, but these are difficult to define and measure amid the complex array of activities that now constitute international banking. Unfortunately, the most common measure of U.S. success in international banking is also one of the least meaningful measures: the number of U.S. banks that are among the largest in the world, as measured by the amount of assets or deposits they control. Clearly, the U.S. has not been faring well in this sense: in 1973, eight of the world's thirty largest banks were U.S.-owned, and by 1988, there was only one, while Japan had seventeen. The figures can be misleading because some changes in rankings are generated by exchange rate movements. As the dollar has weakened, banks whose assets are largely denominated in another currency have surged

in relative size. There are also significant accounting and tax differences among nations that affect banking figures.

There is a fragmented nature of banking in the U.S.; in contrast to the concentration of banking assets in other countries. In each of the major European countries and in Canada, a half-dozen banks account for up to 75 percent of the domestic market. Japan has a total of only 150 banks. By contrast, U.S. banking assets are spread among some 13,000 banks. Because U.S. banking assets are dispersed so widely, only a small percentage of U.S. banks have achieved the critical mass of assets, products, and managerial resources needed to enter international markets.

Although reaching certain size limits is necessary to compete internationally, being among the very biggest is not crucial. Clearly, there are benchmarks more meaningful than size, but many of them do not speak well for U.S. banking. For example, the U.S. share of international banking assets declined from 27.2 percent in 1983 to 14.1 percent in 1989, while Japan's share increased over the same period from 20.5 percent to 38.3 percent. The most recent estimates show that Japanese banks, like U.S. banks, have stopped increasing their market share, and the European banks are now growing most rapidly.

There is another measure that raises questions about the commitment of U.S. banks to international banking: The Federal Reserve Board reports that the number of overseas branches of U.S. banks reached a peak of 916 in 1985, and then fell to 849 in 1988. According to the Congressional Research Service, the foreign assets of U.S. banks dropped almost 20 percent between 1981 and 1989, from \$390 billion to \$318

billion, and the data for 1989 showed a further drop. The U.S. is the only industrial country whose international banking assets have shrunk since 1983.

The Need for Regulatory Reforms

Regulatory reforms are needed because it is U.S. regulations that are restricting United States banks internationally. It is important to realize that regulatory changes are necessary but not sufficient to enhance the competitiveness of U.S. banks. Actions are not only needed in Congress, but also by banking executives.

The nation seems to be edging toward a consensus on several banking regulatory issues. The geographic limits on bank branches have been thoroughly undercut by agreements allowing regional banking in thirty-three states as well as sales of distressed thrifts to distant banks. As a result, these limits will likely be discarded. Even with these changes, local banks are likely to retain their franchises in many places.

The separation between commercial banking and investment banking no longer seems to be in existence. The Fed has been granting a steadily expanding list of securities powers to banks, and this trend is likely to continue. The growing trend toward tapping financial markets directly has led banks to attempt to serve their customers by becoming underwriters and dealers in financial markets. Regulations must catch up with this reality. Regulators must also begin to think about the relationships between banking and insurance. A movement toward the mixing of banking and insurance has surfaced in Europe, and U.S. regulators will have to respond to similar trends in this country. They will also have to resolve issues involving foreign firms that are involved in both banking and insurance and want to undertake both activities in the United States. This trend has the potential to raise important questions regarding

extraterritorial jurisdiction (Bellanger). According to Bellanger, "Whatever specific choices are made, U.S. banking reform must be guided by four rules:

- * The U.S. needs comprehensive regulatory reform rather than piecemeal review;
- * The reforms must facilitate geographic and product diversification to enhance efficiency and promote diversification of risks;
- * These rules must result in uniform regulations for institutions offering similar services, regardless of the nature of those institutions; and
- * The rules must be mindful of international operations and supervision and seek regulatory convergence."

Banking has become too international for any nation to go its own way in regulating banks. The creation of the Eurodollar market remains the classic illustration of this point.

Continental Europe has favored a universal banking format in which a bank offers a wide range of products and services. In the United Kingdom and several Commonwealth countries, banks offer many services through subsidiaries of the bank. The traditional U.S. structure is a holding company that owns a bank, plus subsidiaries that engage in financial services not offered by the bank.

A new regulatory framework would go a long way toward making U.S. banks more effective international competitors, but more than new rules are needed. U.S. bankers also need a stronger commitment to international banking.

If United States banks are given a more appropriate regulatory framework and better strategic sense, they will be very important competitors in world markets. The American ability to innovate is a very valuable attribute. Combine that with the vast

resources that many U.S. banks can muster, and they have a formula for success in many markets. There is reason to be confident that U.S. banks will recapture the leadership they had in the 1990s as they once had in the 1960s (Bellanger).

Financial Institutions: Leading up to the 1990s

Recently, the Clinton Administration has endorsed an overhaul of the nation's financial system that would include interstate banking, simplified regulations and greater access to overseas markets. A leading banking group approved these initiatives, but they were looked at more cautiously by a consumer group (McClain).

The Future of Banking in the United States

The 1990s are and will be a whole new environment for liquidity. Cash will be king in this decade, but rate will no longer guarantee a supply of cash. The future of banking will be a reflection on the past. The recessions of the 1950s and 1960s were essentially inventory adjustments in the absence of rigorous business-cycle control mechanisms. By the early 1960s, finance took on new dimensions with the invention of the certificate of deposit. Treasurers began to move towards control over corporate cash, having less dependence on banks as a source of cash and more towards self-sufficient debt and investment (Martino).

In the 1970s, the beginning of instantaneous funds transfer anywhere, in any currency, provided the capability for greater corporate control of cash, investment, and debt.

By the 1980s, corporations were placing their own instruments on the market and borrowed less from banks, banks chased high-yield loans and increased the range of services offered to increase profit, junk bonds provided an easy path to cash,

restructuring was a greater source of wealth than business growth, and the voodoo economics of supply-side economics gave no heed to the cost of debt. The results were predictable: the collapse of major banks, the S&L debacle, huge trade imbalances with Japan and Germany, excessive national deficits, and the current liquidity crunch. In the 1980s, in the triple attempt to increase debt, lower its cost, and give corporate control over cash, commercial paper volume rose dramatically.

The last four decades may now be looked on as times of easy money, even if the cost was often high, as it was in the early 1980s. Now the cost is low, but cash will not necessarily come. Greater attention must be paid to exactly how much cash is needed, when, and who is a likely source. Without investors, all the effort at self-funding will come to naught. Not only will the cost of debt spiral, but the amount of debt will be diminished. This will lead to a crunch, which in turn, will cause a reduced credit rating, which will then trigger a greater crunch. This cycle will intensify the crunch. This is what is happening now (Martino).

In the U.S. today banks need better loans, and business needs more cash. Bank rates are now low, and terms can certainly be longer than a few days. Stability is not only called for, but possible. The U.S. has gone full circle from banks as sources of cash, to corporations becoming banks, to banks once again fulfilling their traditional role.

Government policy will intensify towards strengthening the base of the banking system, and government policy will most certainly move to alleviate the credit crunch for corporations. Liquidity is more vital today than ever. The safest course of action is to pay attention to business and borrow the least amount necessary and for the longest

term possible. Invest carefully and watch the cash flow, in other words, slow, steady and stable is the best course of action for profitable results (Martino).

Alternatives For the BIF

To correct the BIF's current financial woe, discussed earlier, three potential financial remedies that rely exclusively on the banking industry itself are on the table: 1) further increases in annual deposit-insurance premiums, 2) a large injection of capital by banks into the BIF, such as the 1 percent of insured deposits that credit unions deposit with the National credit Union Share insurance Fund, and 3) a substantial increase in the BIF's line of credit at the treasury department, from the current \$5 billion to something like \$70 billion, with later repayment by banks over an extended period. Both options two and three would gain the BIF quick access to substantial additional resources to resolve failed banks (Barth).

The Future of Banking Institutions

The future of U.S. banking offers additional services for banking participants. In the financial services industry, an entirely new generation of customers, who have always had access to ATMs for routine transactions, expect that innovative financial institutions will continue to extend the convenience and efficiency of electronic funds transfer beyond the bounds of ATM networks. While the future of home information services is far from a sure thing, there is still solid evidence to suggest that the demand for these services may still be stronger than had originally been thought (Thacker).

ATMs have revolutionized, they not only can make withdrawals and deposits, but they can also transfer money between bond mutual funds and stock funds. Since the

first ATM appeared in Atlanta in 1971, 87,000 have appeared across the U.S. They are not just dispensing cash any more.

Wells Fargo now lets customers buy more shares and move cash between as many as five of its 11 Stagecoach mutual funds. Customers can transfer money to existing fund accounts from their bank account.

Citibank will let you transfer money to your Citibank money market mutual fund and check your fund balances through an ATM. Citibank and several other banks including Fleet, also may soon offer switching between funds by ATM.

PNC Bank Corp. has thirty ATMs that can cash checks down to the penny. The ATM can read your account numbers at the bottom of the check, so you do not need a deposit slip. The size of the check you can cash depends on a preset check-cashing limit, which depends on who issues the check and your relationship with the bank.

Seafirst bank's ATMs will sell you postage stamps and bus passes. Some Seafirst ATMs dispense gift certificates for stores at Seattle-area malls. ATMs are big cost-savers for banks, they do not demand raises or need health plans.

Other ATM services include: dispensing rolls of coins, making mortgage or credit card payments and printing highly detailed account summaries. ATMs of the future may do even more. NCR is working on an ATM that will scrap the personal identification number. Instead it will recognize your voice. It will even be able to adjust for aging or a cold. Some super-advanced ATMs are being tested. The machines, produced by Personal Financial Assistant, will let you fill out loan applications and talk by two-way video (Waggoner).

Another service some banks are offering, such as Harris Trust & Savings Bank, is that they are offering credit to those who are unable to obtain credit due to past problems. There is a catch, in order to get a Visa or MasterCard, a potential customer must place \$300 to \$2,000 in a Harris certificate of deposit. The CD amount will set the cardholder's credit limit. That way the bank is protected if a cardholder does not pay for charges. After two years, the cardholder will have an opportunity to get an unsecured card and will be able to cash in the CD.

Secured cards are designed for consumers who have filed for bankruptcy or have other past problems that have prevented them from obtaining credit. Due to their larger inherent risks, the secured cards tend to carry higher fees and interest rates than unsecured cards (Britt).

Conclusion

The United States banking system has declined in recent decades, but with the adoption of interstate banking, simplified regulations, greater access to overseas markets, and offering more services for the public, the U.S. banking system could become one of the leaders of the future. The adoption of interstate banking would allow stronger banks to serve weaker parts of the country. Simplified regulations would allow U.S. banks to compete with other financial institutions and foreign competition. Also, greater access to overseas markets would allow banks to have a greater number of customers. Lastly, more services for the public will dissuade customers from using other forms of financial institutions.

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